

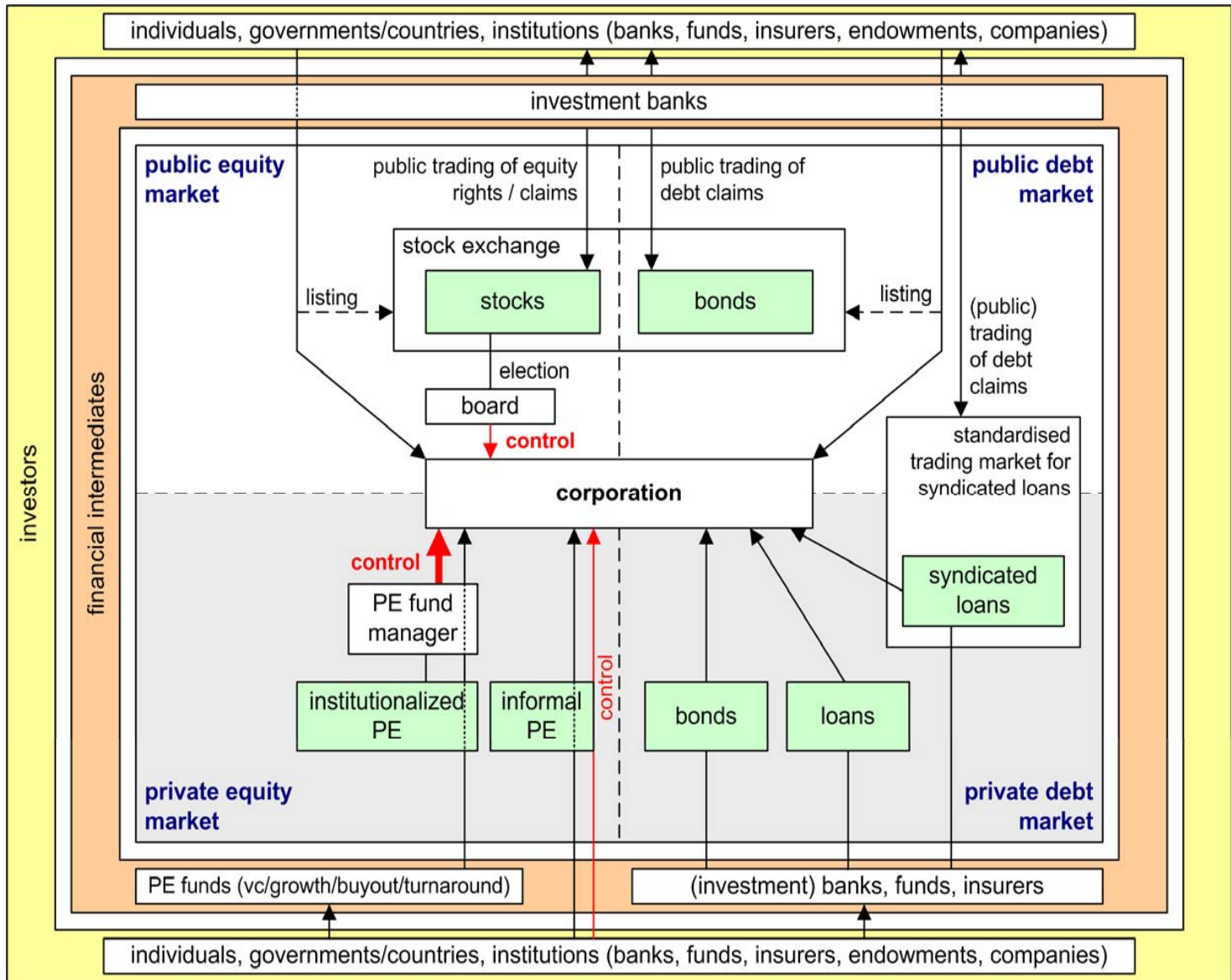
# Private equity 2.0

Tim Jenkinson

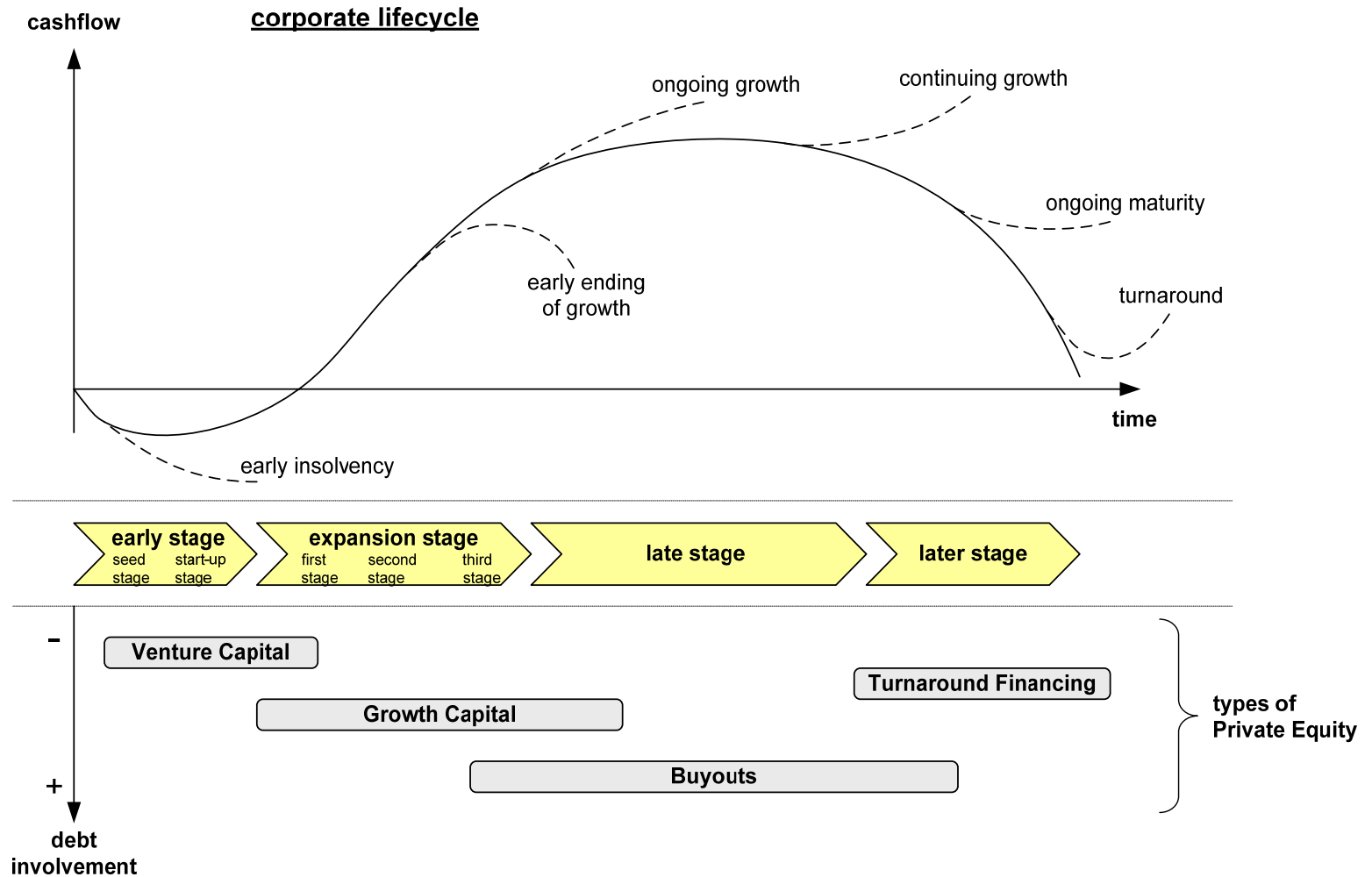
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# What's next for private equity?

- Start with a brief primer on private equity
- Are the glory days over?
- Is private equity entering a “Platinum age”?
- Is there a new model for private equity?

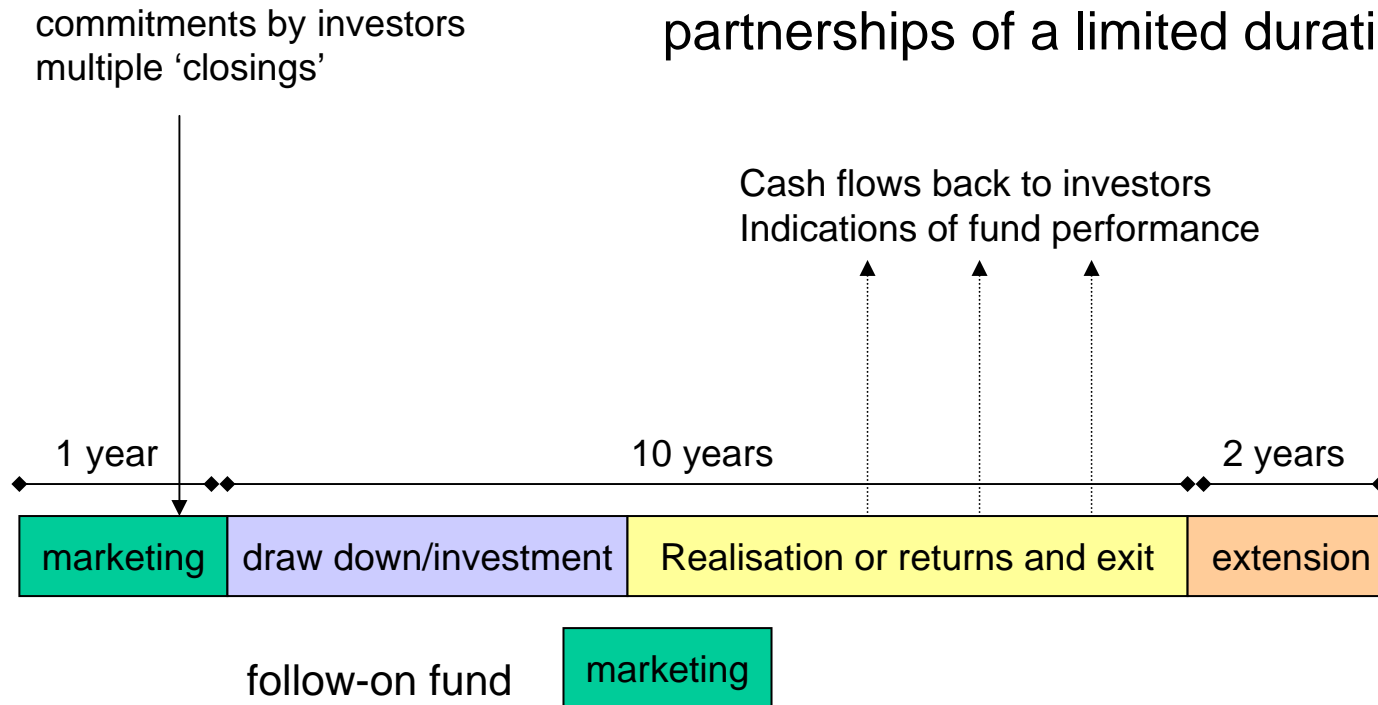


# stages of private equity funding

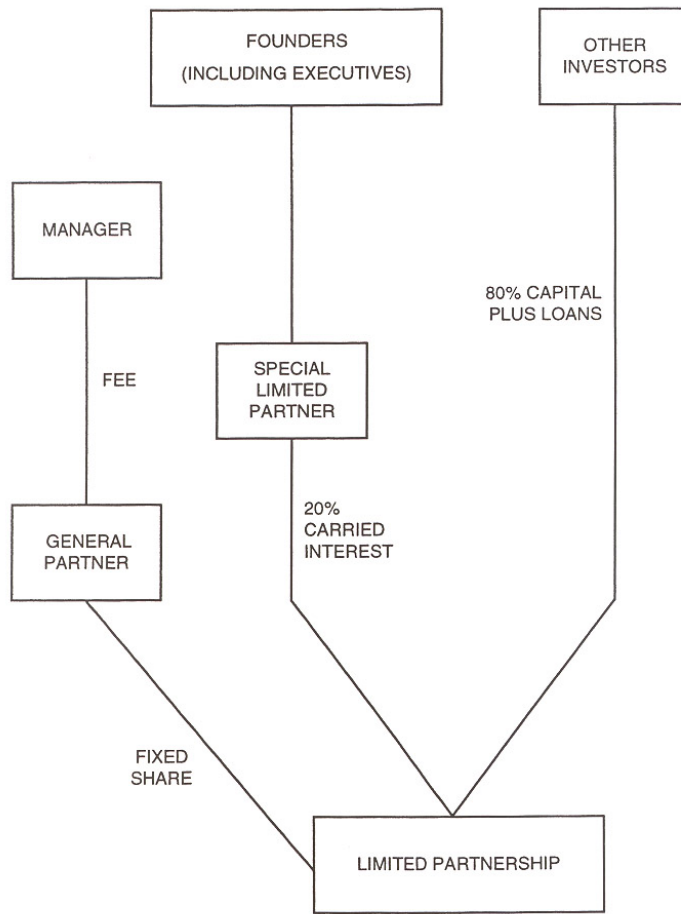


# how are buyout funds structured?

most private equity is invested via partnerships of a limited duration



# limited partnerships



- investors are LPs with liability limited to their commitment
- PE house is the General Partner (GP) with unlimited liability
  - but it is usually a limited company
  - sometimes the executives are employed by a Fund Adviser (for regulatory or fiscal or control reasons) that advises the GP
- the PE professionals personally (usually) are Special Limited Partners
  - SLP's get 20% of profit (after a hurdle rate)
  - SLP's put up little cash for this
  - (although increasing requirement to invest alongside)

# fees and profit share

- annual fees at ~ 2% of committed capital
  - varies from 1% to 3%
  - large buyout funds are closer to 1.5%
  - and fees drop after investment period
- “carried interest” usually equal to 20% of profits
  - profits are worked out on the basis of the entire fund; losses are netted against profits
  - but if the fund produces an overall loss, PE fund does not share in the losses
  - there is often a hurdle to jump, such as 8% IRR
- carried interest is often taxed as capital gains – hence the current debate in various countries which has brought private equity political and media attention, most of it negative

# Glory days are over?

- In recent years, the ingredients have come together for PE
  - more willingness to lend; lower interest rates and margins
  - ability to re-leverage, re-sell, withdraw cash quickly – good for IRR
- Today's environment is much more challenging
  - de-leveraging of financial system and lack of new CLOs means PE must revert to less leveraged structures
  - longer holding periods; more focus on operational improvements
  - multiple contraction on exit; many recent deals deep under-water?
- Private equity is not so private anymore
  - increased focus on the sources of value creation and the economic and social impact on portfolio companies
  - tax benefits under threat; pension regulators are flexing muscles
  - public to private deals likely to be hard (expensive) to execute
  - increased focus on fees, partly due to PE firm flotations

# Academic doubts

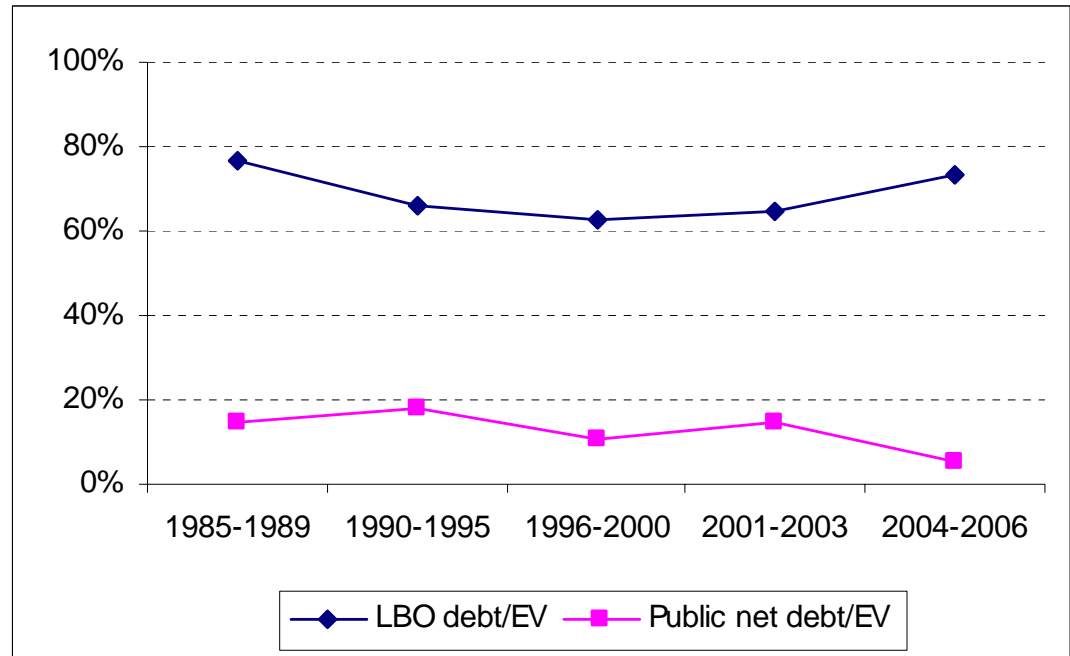
- Performance index (PI) measures returns relative to the unleveraged S&P
- Returns are not so great
- Funds raised between 1980–96 under-performed by 3.3% p.a.
- Excess returns eaten in fees
- In last decade about USD 1.5 trillion in equity has been raised – so conclusions on returns may change

	PI		IRR	
	VC	Buyouts	VC	Buyouts
25 <sup>th</sup> percentile	0.37	0.51	0.21%	1.29%
50 <sup>th</sup> percentile	0.64	0.81	6.34%	9.60%
75 <sup>th</sup> percentile	0.99	1.09	14.95%	18.31%

Source: Phallipou and Zollo, 2007

# Academic questions

- Leverage in LBOs and public cos. appear unrelated
- Are public firms acting sub-optimally?
- And/or is capital structure driven by the option-like contract of PE managers?
- What drove growth of secondary deals? Estimated secondary buy-outs at USD 86 bn in the H1 2007; trade sales estimated at USD 65 bn and IPOs at USD 39 bn
- Do secondary transactions bring new ideas from new owners, or are they driven by the desire to crystallise IRR and carried interests?



Source: Axelson, Jenkinson, Stromberg & Weisbach, 2007

# Platinum age?

- PE will come through its difficulties
  - not many deals will default (due to loose lending conditions)
  - many in-progress deals will not happen
  - leverage in future deals will fall, credit spreads will rise, and covenants will return to previous levels
  - eventually leveraged lending will return and grow
- Assets will continue to flow into the sector
  - estimates of the stock of PE AuM are around USD 1 trillion, or <1% of the estimated \$110 trillion of total assets
  - 2005/6 Russell Survey on Alternative Investing suggests average intended allocations to PE of 8%
  - PE is claimed by many to be a source of alpha: the returns are “better than anything you can legally do with your money” David Rubinstein

# Private equity 2.0

- Does PE technology work in other situations?
  - some PE firms are willing to retain public equity (e.g. the failed ITV deal)
  - PE firms taking minority stakes in public companies, and work with management (e.g., Blackstone's 4.5% stake in Deutsche Telecom bought for £2 bn in April 06 - "expressly welcomed" by incumbent DT management)
- Some strategies mirror activist investors or hedge funds – influence rather than control
- Most hybrid public/private equity strategies do not appear to have much general logic that could be applied widely in other deals
- As leading PE brands become established, permanent capital vehicles for PE are likely to grow, increasing liquidity and access

# Public equity 1.1

- Can PE strategies be implemented in public companies?
- Capital structures remain inverted
- Even PE-backed firms returning to public markets typically use proceeds to pay-down debt
- LPs are also typically investors in public equity, so who's stopping the use of greater leverage, or PE-style incentives and compensation packages?
- Is steady dividend growth still the mantra for public equity investors?
- I expect to see some limited convergence

# Conclusions

- The particularly benign conditions for PE resulted in the current indigestion, and the need to work out some 06/07 investments
- Lending and operating practices will return to more traditional modes
- PE sector will grow, as investors continue to increase allocations to alternative investments
- Current fee levels look unsustainable, especially for the larger PE funds
- Greater transparency on the measurement and sources of alpha is inevitable, and will likely show that PE is no magic wand – this is an area crying out for proper research
- Recent innovations with PE working with public markets are unlikely to become the norm, but publicly quoted funds may increase
- Governance and capital structure benefits that PE can bring means some limited adoption of the PE model by public companies is likely